



MERGERS AND ACQUISITIONS



Taxation of Cross-Border
Mergers and Acquisitions

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TAX

India

Introduction

The legal framework for business consolidations in India consists of numerous statutory provisions for tax concessions and tax neutrality for certain kinds of reorganizations and consolidations. This chapter describes the main provisions for corporate entities. Tax rates cited are for the financial year ending 31 March 2009.

Recent Developments

The following recent developments in the Indian tax and regulatory framework may affect transaction-structuring.

Limited Liability Partnerships (LLPs)

The Limited Liability Partnerships Act was passed in 2009. Previously, the India law only provided for partnerships with unlimited liability. The introduction of this law, paved the way for setting up LLPs in India. Under law, an LLP operates as a separate legal entity, able to enter into binding contracts. LLPs are taxed as normal partnerships; that is, the profits earned by an LLP are taxed in the hands of the LLP, and shares of profit are exempt in the hands of the partners. The law is new and remains unclear in some areas, notably whether foreign investments in an LLP are permissible.

Direct Tax Code

A new draft Direct Tax Code was published by the Finance Ministry for comments from the public. This code, which proposes to replace the existing Income Tax Act, is aimed at simplifying existing provisions and procedures. In its present form the proposed new code may pose problems for companies considering corporate restructuring and the form and content of the code that will finally be enacted are still unclear.

Asset Purchase or Share Purchase

The acquisition of the business of an Indian company can be accomplished by the purchase of shares or the purchase of all or some of the assets. From a tax perspective, long term capital gains arising on a sale of shares through the recognized stock exchanges in India are exempt from tax. All other gains on sales of assets are taxable. Further, in some cases, in addition to capital gains taxes, other transfer taxes such as stamp duty, etc. may also be levied. A detailed comparison of asset

and share purchases is provided at the end of the chapter.

Purchase of Assets

Purchase of assets can be effected in two ways, on a slump-sale or itemized sale basis. The sale of a business undertaking is on a slump-sale basis when the entire business is transferred as a going concern for a lump-sum consideration; cherry-picking of assets is not possible. An itemized sale is when only specific assets/liabilities are transferred and cherry-picking of assets by the buyer is an option. The implications each type of transaction are described later in the chapter.

Purchase Price

The actual cost of the asset will be regarded as the cost of the asset for tax purposes. However, this general rule may be subject to some modifications depending on the nature of asset and the transaction involved. Allocation of the purchase price in case of a slump-sale is critical from a tax perspective, because the entire business undertaking is transferred as a going concern for a lump-sum consideration. Allocation of the purchase price on a fair value or other reasonable commercial basis is normally accepted by the tax authorities and reports obtained from independent valuers are also acceptable.

In the case of itemized sale transactions, the cost paid by the acquirer as agreed upfront, may be accepted as acquisition cost, subject to certain conditions. Thus, under both a slump-sale and an itemized sale, a step up in the cost base of the assets may be obtained.

Goodwill

Goodwill arises when the consideration paid is higher than the total fair value/ cost of the assets acquired. This arises only in situations of a slump-sale. Under the tax law only depreciation/amortization of intangible assets such as know-how, patents, copyrights, trademarks, licenses, and franchises or any other business or commercial rights of a similar nature, is permissible. Thus, when the excess of consideration over the value of the assets arises because of these intangible assets, a depreciation allowance may be available. Currently, the tax law does not permit depreciation of goodwill and since judicial precedents

have yet to challenge this treatment, the chances of allowance for depreciation of goodwill appear remote.

Depreciation

Depreciation charged in the accounts is ignored for tax purposes. The tax laws provide for specific depreciation rates for the tangible assets (buildings, machinery, plant or furniture) depending on the nature of asset used in the business. Additional depreciation of 20 percent is available for new plant and machinery used in manufacturing or production, subject to certain conditions. Depreciation on intangible assets (described above) is normally allowed on a flat rate of 25 percent.

Depreciation is allowed on a block of assets concept. All assets of a similar nature are classified under a single block and any additions/ deletions are made directly in the block. The depreciation rates are on a reducing balance basis on the entire block. However, for companies engaged in the generation and/ or distribution of power, there is an option to claim depreciation on a straight-line basis. Further, in the first year, if the assets are used in the business for less than 180 days, only half of the entire eligible depreciation for that year is allowed as a deduction. When the assets are used for more than 180 days in the first year, the entire eligible depreciation for that year is allowed on the value of the assets. Capital allowances are available for certain types of asset, such as research and development assets or other specified businesses, subject to certain conditions.

Tax Attributes

Tax losses are normally not transferred on any method of asset acquisition. They are retained by the seller.

However, certain tax benefits/ deductions which are available to an undertaking may be available to the acquirer when the undertaking as a whole is transferred as a going concern as a result of a slump-sale.

The Income tax Act grants power to the tax authorities to regard certain asset purchase as void when tax litigations against the transferor is pending. In the absence of clearances from the tax authorities on such a sale, adequate indemnities/warranties are normally sought in the sale agreement.

Value-Added Tax (VAT)

Based on judicial precedent, state level VAT/sales tax should not apply to the sale of a business as a whole on a going concern basis with all its assets and liabilities comprising movable and immovable property, including stock in trade and other goods, for a lump sum

consideration (that is, a separate price has not been assigned to each asset or liability). Sales tax or VAT is a state levy, however, so the provisions of the laws of the state/states concerned should be examined before the transaction.

Unlike a slump-sale, in an itemized sale, there is a transfer of individual items for a value specified for each asset transferred. Since the intention is clearly to sell goods as goods, there may be a liability to VAT on the consideration paid for such goods.

There are mainly two rates of VAT: 12.5 percent and 4 percent, but rates vary from state to state. Depending on the nature of the item sold input credit of tax paid by the transferor could be available to the transferee and thus would not be a cost to the transferee.

Transfer Taxes

The transfer of assets by way of a slump-sale would attract stamp duty. Stamp duty implications differ from state to state. Rates generally range between 5 percent and 10 percent for immovable property, and 3 percent and 5 percent for movable property, usually based on the amount of consideration received for the transfer or the market value of the property transferred, whichever is higher. Depending on the nature of the assets transferred, appropriate structuring of the transfer mechanism may reduce the overall stamp duty cost. The transfer taxes in an itemized sale would be identical to those in a slump-sale.

Purchase of Shares

Businesses can also be acquired through a purchase of shares. No step-up in the cost of the underlying business is possible in a share purchase, because the ownership of the asset is retained by the company itself. No deduction is allowed for a difference between the underlying net asset values and the consideration paid. Furthermore, the sale of shares is taxed as capital gains in the hands of the seller (see Concerns of the Seller).

Tax Indemnities and Warranties

In a share acquisition, the purchaser takes over the target company together with all its related liabilities, including contingent liabilities. The purchaser will, therefore, normally require more extensive indemnities and warranties than in the case of an asset acquisition. An alternative approach is for the seller's business to be transferred into a newly formed entity with a view to the purchaser taking a clean business leaving the liabilities behind. Such a transfer may have tax implications. Where significant sums are involved, it is

customary for the purchaser to initiate a due diligence exercise, which would normally incorporate a review of the target's tax affairs.

Tax Losses

Tax losses consist of normal business losses and unabsorbed depreciation (if there is insufficient income to absorb the current year depreciation as well). Both the losses are eligible for carry-forward and available for the purchaser. Business tax losses can be carried forward for a period of eight years and offset future profits. Unabsorbed depreciation can be carried forward indefinitely. However, one essential condition for setting off business losses is the shareholding continuity test; that is, the beneficial ownership of shares carrying at least 51 percent of the voting power at the end of the year in which the loss was incurred and the year in which the loss is proposed to be set off, must be the same. The shareholding continuity test only applies to business losses and not for unabsorbed depreciation and only applies to unlisted companies (in which the public are not substantially interested).

Transfer Taxes

Securities transaction tax (STT) may be payable if the sale of shares is through a recognized stock exchange in India. STT is imposed on purchases and sales of equity shares listed on a recognized stock exchange in India at 0.125 percent per delivery based purchase or sale and is payable both by the buyer and the seller. In case of non-delivery based transactions, STT is levied at 0.025 percent and is payable only by the seller.

Transfers of shares (other than those in de-materialized form, which are normally traded outside the stock exchanges), are subject to transfer taxes; that is, stamp duty, at the rate of 0.25 percent of the market value of the shares transferred.

Tax Clearances

As in the case of an asset sale, the tax authorities have the power to regard certain transfers of assets (including shares) as void if tax litigation is against the transferor. In the absence of clearances from the tax authorities on such a sale, adequate indemnities/warranties are normally sought in the sale agreements.

Choice of Acquisition Vehicle

Several possible acquisition vehicles are available to a foreign purchaser and tax and regulatory factors often influence the choice of vehicle.

Local Holding Company

Acquisitions through an Indian holding company are governed by the downstream investment guidelines issued in 2009 under Foreign Direct Investment (FDI) policy. At a broad level, any indirect foreign investments (through Indian companies) will not be construed as foreign investments if the intermediate Indian holding company is either owned or controlled by resident Indians. The criteria for deciding the ownership and control of an Indian company are ownership of more than 50 percent of the shares and control of the governing board. Downstream investments made by Indian entities will not be included when judging whether these criteria are met.

Dividends in India are subject to a dividend distribution tax (DDT) of 16.995 percent. A parent company may be able to obtain credit for the DDT paid by its subsidiaries against its DDT liability on dividends declared, but not if the parent is a subsidiary of another company. Thus, in the case of an India holding company, it may not be possible to claim credit for the DDT paid by its subsidiary, making this repatriation strategy inefficient

Foreign Parent Company

The foreign investors may invest directly through the foreign parent company subject to the prescribed Foreign Investment Guidelines. In the case of an asset purchase, it is necessary to establish whether the foreign entity risks creating a permanent establishment (PE) in India.

Non-Resident Intermediate Holding Company

An intermediate holding company resident in another territory could be used for investment into India, to minimize the tax leakage in India such as withholdings at source, capital gains taxes on exit, etc. This may allow the purchaser to take advantage of a more favorable tax treaty with India. This, however, will require evidence of substance in the intermediate holding company's jurisdiction.

Local Branch

Setting up a branch in India is regulated by the Reserve Bank of India (RBI). The prescribed guidelines do not permit a foreign company to use the branch as an acquisition vehicle for acquiring Indian assets.

Joint Ventures

Joint ventures are normally used when there are specific sectoral caps mentioned under the Foreign Investment guidelines. In such scenarios, a joint venture with an Indian partner is set up, which will later acquire the Indian target. One should, however, be aware of the

latest guidelines for calculating the indirect foreign investments.

Choice of Acquisition Funding

A purchaser using an Indian acquisition vehicle to carry out an acquisition for cash will need to decide whether to fund the vehicle with debt or equity, or even a hybrid instrument that combines the characteristics of debt and equity. The principles underlying these approaches are discussed below.

Debt

Tax-deductibility of interest makes debt funding an attractive method of funding. Debt borrowed in foreign currency is governed by the External Commercial Borrowing (ECB) guidelines issued by the Reserve Bank of India (RBI), which impose restrictions on ECB in terms of the amount, the term, cost, end use and remittance into India, which prohibit an Eligible Borrower of ECBs to use the proceeds to fund any acquisition of shares or assets.

Borrowing funds from an Indian financial institution is worth considering, because interest on such loans can be deducted from the operating profits of the business to arrive at the taxable profit. This option is likely to have the following advantages:

- No regulatory approvals required
- Flexibility in repayment of funds
- No ceilings on rate of interest
- No hedging arrangements are required
- No withholding tax (WHT) on interest

Deductibility of Interest

Normally, the interest accounted for in the company's books of accounts will be allowed for tax purposes. Interest on loans from financial institutions or banks is normally only allowed when actually paid. Other Interest (to residents and non-residents) is normally deductible from business profits, subject to the condition that appropriate taxes have been withheld thereon and paid to the government treasury.

No thin-capitalization rules are prescribed in India.

Withholding Tax on Debt and Methods to Reduce or Eliminate

An interest payment by Indian company to non-residents is normally subject to WHT of 22.66 percent. However, the rate may be reduced under a double tax

avoidance treaty, subject to the conditions mentioned therein.

Checklist for Debt Funding

- Debt is raised in foreign currency must conform with ECB guidelines.
- Consider the WHT on the interest expenses for domestic and foreign debt
- Assess whether the profits in the Indian target entity are sufficient to make the interest deduction effective
- All external borrowings (foreign debt) from associated enterprises should comply with the transfer pricing rules

Equity

Most of the sectors have been opened up for foreign investment and, hence, no approvals from the government of India should be necessary for the issue of fresh shares with respect to these sectors. Certain sectors are subject to restrictions or prohibitions of foreign investment where the foreign investor would have to approach the government of India for a specific approval. Pricing of the shares would have to be as per the guidelines issued by the Reserve Bank of India, the central banking and monetary authority in India. Further, any acquisition of equity through a share swap would require approval from the Foreign Investment Promotion Board (FIPB).

Dividends can be freely repatriated under the current Exchange Control Regulations. Equity dividends can be declared only out of profits (current and accumulated), subject to certain conditions.

Under current Indian tax laws, dividends paid by domestic companies are not taxable in the hands of the shareholders. There is no WHT at the time of the distribution of dividends to the shareholders. However, the domestic company needs to pay dividend distribution tax (DDT) at the rate of 16.995 percent (income-tax 15 percent plus a surcharge¹ of 10 percent, and education cess of 3 percent) on the amount of dividends actually paid to the shareholders. Dividends are not a tax-deductible cost. However, an Indian parent company can take credit for the DDT paid by its subsidiary, subject to certain conditions.

As per the present company law provisions, equity capital cannot be withdrawn during the life-span of the

¹ Surcharge is applicable at 10 percent for a domestic company and 2.5 percent for a foreign company only if income is in excess of INR 10 million.

company, except in the case of a buy-back of shares. Under the company law provisions, 10 percent of the capital can be bought back with the approval from the Board of Directors and up to 25 percent can be bought back with prior approval of shareholders, subject to other prescribed conditions.

Mergers

One of the most popular and tax-efficient means of corporate consolidation in India is amalgamation. Amalgamation enjoys favorable treatment under income tax and other laws, subject to fulfillment of stipulated conditions. The important provisions under Indian laws relating to amalgamation are discussed below.

Tax-Neutrality

Under Indian tax law, amalgamation is defined to mean a merger of one or more companies into another company, or the merger of two or more companies to form a new company so that:

- All the properties and liabilities of the merging companies (amalgamating companies) immediately before the merger become the properties and liabilities of the company into which the merger takes place (amalgamated company).
- Shareholders holding at least three-quarters of the shares in the amalgamating companies become shareholders of the amalgamated company. (The shares already held, if any, by the amalgamated company or its nominees are excluded for the purposes of calculation.)

With effect from 1 April 2005, the transfer of a capital asset by a banking company to a banking institution in a scheme where a banking company is amalgamated with a banking institution as directed and approved by the Central Government/RBI, will not be regarded as a transfer for the purposes of capital gains. The cost of acquiring the capital asset thus transferred is deemed to be the cost at which the amalgamating banking company acquired it.

Generally, the transfer of any capital asset is subject to capital gains tax in India. However, amalgamation enjoys tax-neutrality with respect to transfer taxes under Indian tax law; both the amalgamating company transferring the assets and the shareholders transferring their shares in the amalgamating company are exempt from tax. To achieve tax-neutrality for the amalgamating company(ies) transferring the assets, the amalgamated company should be an Indian company. In addition, to achieve tax-neutrality for the shareholders of the

amalgamating company(ies), the entire consideration would have to be paid in the form of shares in the amalgamated company.

Carry-Forward and Set-Off of Accumulated Losses and Unabsorbed Depreciation

Unabsorbed business losses including depreciation (that is, amortization for capital assets) of the amalgamating company(ies) are deemed to be the unabsorbed business losses and depreciation of the amalgamated company for the year in which amalgamation takes place. In effect, the business losses get a new lease of life for eight years for carry-forward.

However, such carry-forward is available only if:

- the amalgamated company owns a ship or a hotel or is an industrial undertaking (manufacturing or processing of goods, manufacturing of computer software, electricity generation and distribution, telecommunications, mining, or constructions of ships, aircraft, or rail systems);
- the amalgamation is of banking companies; or
- the amalgamation is of public sector company(ies) engaged in the business of operating aircraft with one or more public sector companies engaged in the similar business.

Carry-forward of losses in case of amalgamations is subject to further conditions under the income tax law.

Other Implications

Other implications of amalgamation include:

- If any business unit (that is, an undertaking) of the amalgamating company(ies) enjoys any tax incentive, generally the incentive can be claimed by the amalgamated company for the unexpired period even after amalgamation.
- The basis for claiming depreciation for tax purposes with respect to the assets of amalgamating company(ies) acquired on amalgamation remains the same for the amalgamated company; that is, no step-up is possible for tax purposes in the value of assets acquired on amalgamation.
- The total depreciation on assets transferred to the amalgamated company in a financial year shall be apportioned between the amalgamating company and the amalgamated company in the ratio of the number of days for which the assets were used by each during the year. Depreciation up to the effective date of transfer shall be available to the

amalgamating company and thereafter to the amalgamated company.

- The expenses of amalgamation can be amortized in five equal annual installments commencing from the year in which the amalgamation takes place.
- Unamortized installments of certain deductions eligible to the amalgamating company(ies) are allowable in the hands of the amalgamated company.

Corporate Law

Corporate reorganizations involving amalgamations of two or more companies require the approval of the Jurisdictional High Court (following a recent amendment, the function of granting approval for corporate mergers is to be transferred to the National Company Law Tribunal, upon notification). The process of obtaining High Court approval normally takes four to six months.

Transfer Taxes

The transfer of assets, particularly immovable properties, requires registration with the state authorities for the purposes of authenticating transfer of title. Such registration requires payment of stamp duty. Stamp duty implications differ from state to state. Generally, rates of stamp duty range between 5 percent and 10 percent for immovable properties and 3 percent to 5 percent for movable properties, generally calculated on the amount of consideration received for the transfer or the market value of the property transferred, whichever is higher. Some of the state stamp duty laws contain special beneficial provisions for stamp duty on a court-approved merger.

The sales tax/VAT implications on court-approved merger s vary from state to state. The sales tax/VAT provisions of most of the states stipulate that the transfer of properties, etc., by way of a court-approved merger between the merging entities would generally attract sales tax/VAT until the date of the High Court Order.

In the absence of such provision, various courts have held the effective date of the merger to be the day the merger scheme becomes operative and not the date of the order of the court. Consequently, in such cases, the transfer of properties between the merging entities during the period from the effective date of merger to the date of the high court order has been held as not liable to sales tax/VAT.

Exchange Control Regulations

In India, capital account transactions are still not fully liberalized. Certain foreign investments require the approval of the government of India. A court-approved merger is specifically exempt from obtaining any such approvals if, post-merger, the stake of the foreign company does not exceed the prescribed sectoral cap.

Takeover Code Regulations

The acquisition of shares in a listed company beyond a specific percentage triggers implications under the regulations of India's stock market regulator, the Securities and Exchange Board of India (SEBI). However, a court-approved merger is specifically excluded from the application of these regulations.

Thus, a court-approved merger is the most tax-efficient means of corporate consolidation or acquisition, subject to the following qualifications:

- More procedural formalities and a longer time frame of four to six months.
- Both the parties must be corporate entities and the transferee company must be an Indian company.

De-Merger

The separation of two or more existing business undertakings operated by a single corporate entity can be effected in a tax-neutral manner. The tax-neutral separation of a business undertaking is termed a 'de-merger.' The key provisions under Indian law relating to de-merger are discussed below.

Income Tax Law

Under Indian tax law a de-merger is defined as the transfer of one or more undertakings to any resulting company, pursuant to an arrangement under sections 391 to 394 of the Indian Companies Act 1956, in such a manner that as a result of the de-merger:

- All the property and liabilities relating to the undertaking being transferred by the de-merged company immediately before the de-merger become the property and liabilities of the resulting company.
- Such property and liabilities of the undertaking(s) should be transferred at values appearing in the books of account of the de-merged company. For determining the value of the property, any revaluation should be ignored.

- In consideration of a de-merger, the resulting company issues its shares to the shareholders of the de-merged company on a pro rata basis.
- Shareholders holding three-quarters of the shares in the de-merged company become shareholders of the resultant company (the shares already held, if any, by the resultant company or its nominees are excluded for the purposes of this calculation).
- The transfer of the undertaking is on a going-concern basis.

Undertaking is defined to include any part of an undertaking or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

In a de-merger, the shareholders of the de-merged company get shares in the resultant company. The cost of acquisition of the original shares in the de-merged company is split between the shares in the resultant company and the de-merged company in the same proportion as the net book value of the assets transferred in a de-merger bears to the net worth of the de-merged company before de-merger. (Net worth refers to the aggregate of the paid-up share capital and general reserves as appearing in the books of account of the de-merged company immediately before the de-merger.)

Generally, the transfer of any capital asset is subject to transfer tax (capital gains tax) in India. However, a de-merger enjoys a dual tax-neutrality with respect to transfer taxes under Indian tax law; that is, both the de-merged company transferring the undertaking and the shareholders transferring their part of the value of shares in the de-merged company are exempted from tax. To achieve tax neutrality for the de-merged company transferring the undertaking, the resultant company should be an Indian company.

Other provisions of the income tax law are:

- The unabsorbed business losses, including depreciation (that is, amortization of capital assets) of the de-merged company directly related to the undertaking transferred to the resultant company are treated as unabsorbed business losses or depreciation of the resultant company. If such losses, including depreciation, are not directly related to the undertaking being transferred, the losses should be apportioned between the de-merged company and the resulting company in the

proportion in which the assets of the undertaking have been retained by the de-merged company and transferred to the resulting company.

- If any undertaking of the de-merged company enjoys any tax incentive, generally the incentive can be claimed by the resulting company for the unexpired period, even after the de-merger.
- The total depreciation on assets transferred to the resulting company in a financial year shall be apportioned between the de-merged company and the resulting company in the ratio of the number of days for which the assets were used by each during the year. Depreciation up to the effective date of transfer shall be available to the de-merged company and thereafter to the resulting company.
- The expenses of a de-merger can be amortized in five equal annual installments commencing with the year in which the de-merger takes place.
- Step-up in the value of the assets is not permissible either in the books or for tax purposes.

Any corporate reorganization involving the de-merger of one or more undertakings of a company requires the approval of the Jurisdictional High Court (as noted above, the function of granting approval for corporate mergers is to be transferred to the National Company Law Tribunal). The process of obtaining High Court approval normally takes four to six months.

The transfer of assets, particularly immovable property, requires registration with the state authorities to authenticate transfers of title. Such registration requires payment of stamp duty, which differs from state to state. The rates range between 5 percent and 10 percent for immovable property and three percent and 5 percent for movable property, generally calculated on the consideration received or the market value of the property transferred, whichever is higher. Some state stamp duty laws contain special stamp duty privilege for court-approved de-mergers.

The sales tax/VAT implications of court-approved merger vary from state to state. Some states are silent on this issue, there are provisions in others that stipulate that when a company is to be demerged by the order of the Court or of the Central Government, it shall be presumed that the two or more companies brought into existence by the operation of the said order have not sold or purchased any goods to each other from the effective date of the scheme to the date of the High Court order.

Exchange Control Regulations

A court-approved de-merger is specifically exempted from obtaining government approval if, post-de-merger, the investment of the foreign company does not exceed the sectoral cap.

A court-approved de-merger is the most tax-efficient way to hive off, subject to the following qualifications:

- More procedural formalities and longer time frame of four to six months.
- Shares need to be allotted to shareholders of demerged company.

Hybrids

Preference capital is also used in some transaction structuring models. A preference capital has preference over equity shares for dividends and repayment of capital, but do not carry voting rights. An Indian company cannot issue perpetual (non-redeemable) preference shares. The maximum redemption period for preference shares is 20 years. Preference dividends can be only declared out of profits. Dividends on preference shares are not a tax deductible cost. Preference dividends on fully convertible preference shares can be freely repatriated under the current Exchange Control Regulations. The maximum rate of dividend (coupon) that can be paid on such preference shares should be as per the norms prescribed by the Ministry of Finance (generally, 300 basis points above the prevailing prime lending rate of the State Bank of India).

The redemption/conversion (into equity) feature of preference shares make them an attractive instrument. Preference capital can only be redeemed out of the profits of the company or the proceeds of a fresh issue of shares made for the purpose. The preference shares may be converted into equity shares, subject to the terms of the issue of the preference shares. On the regulatory front, where the foreign investment is made through fully compulsorily convertible preference shares, it is treated at par with equity share capital. Accordingly, all regulatory norms applicable for equity will be applicable for such securities. Other types of preference shares (non-convertible, optionally-convertible, or partially-convertible) are considered as debt and have to be issued in conformity with ECB guidelines in all aspects. Because of the ECB restrictions, such non- and optionally-convertible instruments are not often used for funding acquisitions.

Another possibility is the issue of convertible debt instruments. Interest on convertible debentures is normally allowed as a deduction for tax purposes, but

like preference shares, all compulsorily convertible debentures are treated on a par with equity and other non-convertible/optionally-convertible/partly-convertible debentures must comply with ECB guidelines.

Other Considerations

Concerns of the Seller

Asset Purchase

Both slump-sales and itemized sales are subject to capital gains tax in the hands of the sellers. In the case of a slump-sale, consideration in excess of the net worth of the business is taxed as capital gains. Net worth needs to be computed as per the provisions of the Income tax Act, 1961. Where the business of the undertaking of the transferor company is held for more than 36 months, such an undertaking would be treated as a long-term capital asset, and the gains from its transfer would be taxed at a rate of 22.66 percent rate for a domestic company and 21.115 percent for a foreign company (including applicable surcharge² and education cess of 3 percent). Otherwise, the gains would be taxed at 33.99 percent for a domestic company and 42.23 percent for a foreign company (including applicable surcharge and education cess at 3 percent).

Capital gains taxes in the case of itemized sale would depend on the nature of assets. These can be divided into three categories:

- Tangible capital assets
- Stock-in-trade
- Intangibles (goodwill, brand, etc.)

The tax implication on a transfer of capital assets (including net current assets other than stock-in-trade) would depend on whether or not they are eligible for depreciation under the income tax act.

In the case of assets on which no depreciation is allowed, consideration in excess of the cost of acquisition and improvement is taxable as a capital gain. If the assets of the business are held for more than 36 months, the assets would be classified as long-term capital assets. For shares in a company, other listed securities, units of mutual funds, and zero coupon bonds the eligible period for classifying it as a long-term asset is reduced to 12 months. The gains arising from transfers of long-term capital assets would be taxed at a 22.66 percent rate for a domestic company and 21.115 percent for a foreign company (including applicable

² Ibid.

surcharge³ and education cess of 3 percent). For the purposes of calculating the inflation adjustment, the acquisition cost of the asset can be the original purchase cost or, if the capital asset was acquired by the taxpayer on or before 1 April 1981, the fair market value as of 1 April 1981, at the taxpayer's option.

If the assets of the business are held for less than 36 months (12 months for shares) capital gains on the sale of such short-term capital assets are taxable at 33.99 percent for a domestic company and at 42.23 percent for a foreign company (including applicable surcharge⁴ and education cess of 3 percent).

In the case of assets on which depreciation has been allowed, the consideration is deducted from the tax written-down value of the block of assets (explained below), resulting in a lower claim for tax depreciation subsequently.

If the unamortized amount of the respective block of assets is less than the consideration received or the block of assets ceases to exist (that is, there are no assets in the category), the difference is treated as short-term capital gains and subject to tax at 33.99 percent for a domestic company and at 42.23 percent for a foreign company (including applicable surcharge⁵ and education cess of 3 percent). If all the assets in a block of assets are transferred and the consideration is less than the unamortized amount of the block of assets, the difference is treated as a short-term capital loss and could be set off against capital gains arising in up to eight succeeding years.

Any gains or losses on the transfer of stock-in-trade are treated as business income or loss. The business income will be subject to tax at 33.99 percent for a domestic company and at 42.23 percent for a foreign company (including applicable surcharge⁶ and education cess of 3 percent). Business losses can be set off against income under any head of income arising in that year. If the current year's income is inadequate, business losses can be carried forward to be set off against business profits for eight succeeding years.

The tax treatment for intangible capital assets is identical to that of tangible capital assets, as already discussed. The issue of claiming depreciation on goodwill acquired has yet to be tested in the courts, but the chances of allowance for depreciation of goodwill appear slim.

³ Ibid.
⁴ Ibid.
⁵ Ibid.
⁶ Ibid.

Share Purchase

When the shares are held for a period of not more than 12 months, the gains are characterized as short-term capital gains, and are subject to tax at the following rates:

If the transaction is not liable to STT:

- 33.99 percent (including applicable surcharge⁷ at 10 percent and education cess of 3 percent) for a domestic company.
- 42.23 percent (including applicable surcharge⁸ at 2.5 percent and education cess of 3 percent) for a foreign company.
- Foreign institutional investors (FIIs) are taxed at a flat rate of 31.67 percent (income tax at 15 percent, a 2.5 percent surcharge⁹, and education cess of 3 percent on the tax plus surcharge).

If the transaction is liable to STT, short-term capital gains arising on transfers of equity shares are taxed at the following rates:

- 16.995 percent (including applicable surcharge¹⁰ at 10 percent and education cess of 3 percent) for a domestic company.
- 15.84 percent (including applicable surcharge¹¹ at 2.5 percent and education cess of 3 percent) for foreign companies and FIIs.

If the shares have been held for more than 12 months, the gains are characterized as long-term capital gains and subject to tax as follows:

If the transaction is not liable to STT:

- The gains are subject to tax at a 22.66 percent rate in case of a domestic company and 21.115 percent in case of a foreign company (including applicable surcharge¹² and education cess of 3 percent). Resident investors are entitled to the benefit of an inflation adjustment when calculating long-term capital gains; the inflation adjustment is computed based on the inflation indices prescribed by the government of India. Non-resident investors are entitled to benefit from currency fluctuation adjustments when calculating long-term capital gains on a sale of shares of an Indian company purchased in foreign currency.

⁷ Ibid.
⁸ Ibid.
⁹ Ibid.
¹⁰ Ibid.
¹¹ Ibid.
¹² Ibid.

- Income tax on long-term capital gains arising from the transfer of listed securities (off the stock market) which otherwise is liable to 22.66 percent/21.115 percent is restricted to a concessional rate of 11.33 percent rate in case of a domestic company. The concessional rate must be applied to capital gains without applying the inflation adjustment.

If the transaction is liable to STT long-term capital gains arising on transfers of equity shares are exempt from tax.

Company Law and Accounting

Companies in India are governed by the Companies Act, 1956. The Companies Act incorporates the detailed regulations for corporate restructuring, including corporate amalgamation/ demerger. All such schemes must be approved by the Jurisdictional High Court under the powers vested in it under the Companies Act. The provisions allowing corporate amalgamations/restructuring provide lot of flexibility. Detailed guidelines are prescribed for other forms of restructuring, such as capital reduction, buy-back, etc.

Accounting norms for companies are governed by the Accounting Standards issued under the Companies Act. Normally, for schemes of amalgamation/demergers/restructurings the respective scheme provides for the accounting treatment to be adopted for the transaction. The accounting treatments are broadly in-line with the provisions of the Accounting Standard covering Accounting for Amalgamations and Acquisitions. The Accounting Standard prescribes two methods of accounting; acquisition accounting and merger accounting. In merger accounting, all the assets and liabilities of the transferor are consolidated at their existing book values. Under acquisition accounting, the consideration is allocated amongst the assets and liabilities acquired (on a fair value basis). Thus, acquisition accounting may give rise to goodwill, which is normally amortized over five years.

Transfer Pricing

Post acquisition, all inter-company transactions, including interest on loans, are subject to transfer pricing regulations.

Foreign Investments of a Local Target Company

Foreign Investments by an Indian target company are regulated by the guidelines issued by the RBI. Broadly, an Indian target entity can invest up to 400 percent of its net worth (as per audited accounts) in joint ventures

or wholly-owned subsidiaries overseas, but investments exceeding USD 5 million may be subject to certain pricing guidelines. There are no controlled foreign companies (CFC) regulations in India.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- Faster execution process, because no court approval required, except in the case of an acquisition of a business through a de-merger, which requires court approval.
- Assets and liabilities can be selectively acquired and assumed, respectively.
- Possible to restate the values of the assets by the acquirer for books and tax purposes, subject to appropriate valuation in a slump-sale and subject to carrying out the transaction at a specified price in an itemized sale of assets.
- Possible to capture the value of brand(s) and intangibles and claim depreciation thereon, subject to appropriate valuation in a slump-sale and subject to carrying out the transaction at a specified price in an itemized sale of assets.
- No requirement to make an open offer, unlike in a share acquisition.

Disadvantages of Asset Purchases

- The transaction may not be tax-neutral, unlike amalgamation and de-merger, among others.
- Approvals may be required from the financial institutions (among others) to transfer assets or undertakings, which may delay the process.
- Continuity of incentives, concessions, and unabsorbed losses under direct or indirect tax laws or EXIM policy (that is, Export and Import Policy of India or now also referred to as Foreign Trade Policy of India) (among others) will have to be considered.
- Stamp duty could be higher.
- Sales tax/VAT implications need to be considered in an itemized sale of assets.

Advantages of Share Purchases

- Faster execution process, because no court approval is required, except in cases where the

open offer code is triggered or government approval is required.

- Typically, securities transaction tax (STT) is levied on a sale of equity shares through a recognized stock exchange in India at the rate of 0.125 percent for each such purchase and sale.
- Gains arising on the sale of STT-leviable assets held for more than 12 months are exempt from tax.
- In the case of a sale of shares (other than listed shares) held for more than 12 months, there is a concessionary rate of tax of 22.66 percent for a domestic company (including applicable surcharge and education tax of 3 percent) after considering a cost inflation adjustment leviable on gains on transfer of such shares.
- No sales tax/VAT applicable.

Disadvantages of Share Purchases

- The transaction may not be tax neutral and there may capital gains taxes in the hands of the sellers.
- Stamp duty cost at 0.25 percent of total consideration payable on shares held in physical form.
- Not possible to capture value of intangibles.
- Step-up in value of assets is not possible.
- Consideration paid toward acquisition of shares is locked in until the shares are sold and embedded goodwill cannot be amortized.
- May require regulatory approval from the Government of India and other regulators such as SEBI, FIPB etc.
- Valuation of shares may be subject to the pricing guidelines of the RBI.
- In the case of an acquisition of shares of listed companies, acquiring more than 15 percent would trigger the SEBI take-over code, which obliges the acquirer would have to acquire at least 20 percent of the shares from the open market at a price determined under a prescribed SEBI formula. This may increase the transaction cost substantially and also significantly increase the time taken to complete the transaction, because the shares would only vest in the acquirer after the completion of the open offer.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends ^a		Interest ¹ (%)	Royalties ² (%)
	Individuals, Companies (%)	Qualifying Companies (%)		
Armenia	10	10	10	10
Australia	15	15	15	10/15 ³
Austria	10	10	10	10
Azerbaijan ²³	15	15	15	15/20 ⁴
Bangladesh	15	10 ⁵	10	10
Belarus	15	10 ⁵	10	15
Belgium	15	15	10/15 ⁶	20
Botswana ²⁴	10	7.5 ⁵	10	10
Brazil	15	15	15	15/25 ⁷
Bulgaria	15	15	15	15/20 ⁴
Canada	25	15 ⁸	15	10/15 ⁹
China (People's Rep.)	10	10	10	10
Cyprus	15	10 ⁸	10	15
Czech Republic	10	10	10	10
Denmark	25	15 ⁵	10/15 ⁶	20
Egypt	0	0	- ¹⁰	- ¹⁰
Faroe Islands	25	15 ⁵	10/15 ⁶	20
Finland	15	15	10	10/15 ⁹
France	15	15	10/15 ¹¹	20
Georgia ²³	15	15	15	15/20 ⁴
Germany	10	10	10	10
Greece	0	0	- ¹⁰	- ¹⁰
Hungary	10	10	10	10
Iceland ¹²	10	10	10	10
Indonesia	15	10 ⁵	10	15
Ireland	10	10	10	10
Israel	10	10	10	10
Italy	25	15 ⁸	15	20
Japan	15	15	10/15 ⁶	20
Jordan	10	10	10	20
Kazakhstan	10	10	10	10
Kenya	15	15	15	20
Korea (Rep.)	20	15 ¹³	15	15
Kyrgyzstan	10	10	10	15
Libya	0	0	- ¹⁰	- ¹⁰
Malaysia	10	10	10	10
Malta	15	10 ⁵	10	15
Mauritius	15	5 ⁸	- ¹⁰	15
Moldova ²³	15	15	15	15/20 ⁴
Mongolia	15	15	15	15
Morocco	10	10	10	10
Namibia	10	10	10	10
Nepal	15	10 ⁸	15	15
Netherlands	15	15	10/15 ¹¹	20
New Zealand	20	20	15	30
Norway	25	15 ⁵	15	20
Oman	12.5	10 ⁸	10	15
Philippines	20	15 ⁸	10/15 ¹⁴	15
Poland	15	15	15	22.5
Portugal	15	10 ¹⁵	10	10
Qatar	10	5 ⁸	10	10
Romania	20	15 ⁵	15	22.5
Russia	10	10	10	10

Country	Dividends ^a		Interest ¹ (%)	Royalties ² (%)
	Individuals, Companies (%)	Qualifying Companies (%)		
Saudi Arabia	5	5	10	10
Serbia ²⁴	15	5 ⁵	10	10
Singapore	15	10 ⁵	10/15 ¹⁶	10/15 ¹⁷
Slovak Republic	25	15 ⁵	15	30
Slovenia	15	5 ⁸	10	10
South Africa	10	10	10	10
Spain	15	15	15	10/20 ¹⁸
Sri Lanka	15	15	10	10
Sudan	10	10	10	10
Sweden	10	10	10	10
Switzerland	15	15	15	10/15 ¹⁹
Syria	0	0	7.5	10
Tajikistan ²³	15	15	15	15/20 ⁴
Tanzania	15	10 ²⁰	12.5	20
Thailand	- ¹⁰	15/20 ²¹	10/25 ¹⁶	15
Trinidad/Tobago	10	10	10	10
Turkey	15	15	10/15 ¹⁶	15
Turkmenistan	10	10	10	10
Uganda	10	10	10	10
Ukraine	15	10 ⁵	10	10
United Arab Emirates	15	5 ⁹	5/12.5 ¹⁶	10
United Kingdom	15	15	15	10/15 ⁹
United States	25	15 ⁸	10/15 ¹⁶	10/15 ⁹
Uzbekistan	15	15	10	15
Vietnam	10	10	10	10
Zambia	15	5 ²²	10	10

Notes

- a. All dividends declared by domestic companies in India are subject to a dividend distribution tax of 15 percent (16.995 percent including applicable surcharges and cess). This tax is levied on the company declaring the dividends. Thus, it is applicable to all domestic companies.
- Many of the treaties provide for an exemption for certain types of interest, such as interest paid to public bodies and institutions or financial institutions, or in relation to sales on credit. Such exemptions are not considered in this column.
 - Some treaties include technical services in the definition of royalties, which are not considered in this column. This column also does not consider the effect of the most-favored-nation clause, such as in the case of the treaties with France and Spain.
 - The lower rate applies to payments for the use of, or the right to use or forbearance of the rights to use, any industrial, commercial or scientific equipment, and the rendering of any technical or consultancy services.
 - The lower rate applies to royalties relating to copyrights of literary, artistic or scientific works, other than cinematograph film or films or tapes used for radio or television broadcasting.
 - The rate generally applies to participations of at least 25 percent of capital.
 - The lower rate applies to interest paid to a bank.
 - The higher rate applies to royalties for the right to use trademarks.
 - The rate generally applies to participations or control of at least 10 percent of capital or voting power, as the case may be.
 - The lower rate applies to payments for the use of, or the right to use, any industrial, commercial, or scientific equipment or related services.
 - The domestic rate applies; there is no reduction under the treaty.
 - The lower rate applies to interest on loans made or guaranteed by a bank or other financial institution carrying on a bona fide banking or financing business or by an enterprise which holds directly or indirectly at least 10 percent of the capital of the company paying the interest.
 - The benefits under the articles for dividends, interest and royalties do not apply if by reason of special measures the tax imposed by Iceland on the recipient corporation, with respect to the dividends, interest, and royalties, is substantially less than the tax generally imposed on corporate profits; and 25 percent or more of the capital of the recipient corporation is owned directly or indirectly by one or more persons who are not individual residents of Iceland.
 - The rate applies if the beneficial owner is a company which owns directly at least 20 percent of the capital of the company paying the dividends.
 - The lower rate applies to interest paid to a financial institution (including insurance companies), or in respect of public issues of bonds, debentures or similar obligations.
 - The rate applies if the beneficial owner is a company that, for an uninterrupted period of two fiscal years prior to the payment of the dividend, owns directly at least 25 percent of the capital stock of the company paying the dividends.
 - The lower rate applies to interest paid to a bank or financial institution, including an insurance company in some cases.
 - Fifteen percent for any copyright of a literary, artistic, or scientific work, including cinematograph films or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience, including gains derived from the alienation of any such right, property or information; 10 percent for any industrial, commercial or scientific equipment, other than payments derived by an enterprise from the specified activities related to sea or air transportation.
 - The lower rate applies to the use of, or the right to use, industrial, commercial, or scientific equipment.
 - Fifteen percent for payments of any kind received, as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematograph films or work on film, tape, or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; 10 percent for payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment.
 - The rate applies if the recipient is a company which owns at least 10 percent of the shares of the company paying the dividends during the six months immediately preceding the date of payment of the dividends.
 - Fifteen percent for dividends paid by a company engaged in an industrial undertaking and the beneficial owner of the dividends is a company owning at least 10 percent of the voting shares of the company paying the dividends; 20 percent for dividends paid by a company engaged in an industrial undertaking or if the beneficial owner of the dividends is a company owning at least 25 percent of the voting shares of the company paying the dividends.
 - The rate applies if the recipient is a company which owns at least 25 percent of the shares of the company paying the dividends during the six months immediately preceding the date of payment of the dividends.
 - The position regarding the applicability of the treaty with the former USSR remains unclear. Currently there is no statement from India regarding the applicability of the treaty in relation to these countries. In practice, these countries, with the exception of Tajikistan, generally do not apply the former conventions. India has concluded new treaties with several other former USSR countries.
 - The treaty is effective for fiscal years beginning on or after 1 April 2009.

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